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CURRENCIES AND CREDIT MARKETS

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"Never did a ship founder with a captain and a crew more ignorant of the reasons for its misfortune or more impotent to do anything about it."

E. J. Hobson, Industry and Empire
Pantheon, New York, 1968, p. 179

HIGHLIGHTS

World bond markets continue to crash. Yet, relative to this devastation, stock markets are still quite resilient. This is an obvious sign of continuing optimism. Isn't there any recognition that sharply rising interest rates will definitely undermine profit growth and economic prospects?

We reiterate again: The Great Financial Bubble has begun its bust. The fact that financial pundits continue to cite "positive long-term fundamentals" and the relative imperviousness of global stock markets suggests that the bust has only just begun.

The true state of liquidity is low; in the U.S., by some measures, it is at a record low. That makes financial markets vulnerable. And to think that the big asset shift away from deposits to financial assets on the balance sheet of individuals has hardly begun to reverse is truly ominous.

The biggest surprise of the year, though, has been the slumping U.S. dollar. Why? What again blind-sided the majority of the global financial community? We review the reasons for our continuing bearishness on the dollar.

The dollar situation could force a terrible dilemma upon the U.S. Fed: Should it tighten policy further to save the dollar, thus sacrificing the financial markets, or should it let the dollar fall, triggering foreign capital flight?

The next consensus viewpoint to break is the bullishness on the budding world economic recovery. In this regard, it is significant that long-term rates have risen faster than short-term rates all around the world. This is not the cyclical norm. As such, the rate rises will bite economies deeply.

Due to special stimulating factors that were operative in the U.S. recovery, the bust of the bubble virtually guarantees a renewed economic slowdown. That alone will be a big negative strike against world growth prospects.

The outlook for securities markets around the world looks uncertain at best. While there are differing underlying fundamentals for each of the markets, we still think that it is much too early to give up any precious liquidity. Hold on to cash.

Ignore all the beckoning siren calls from the vested interests. Investors should continue to limit themselves to short-term bonds in the hard currency markets and cash-equivalent investments.

THE BUST OF THE GREAT FINANCIAL BUBBLE HAS BEGUN

It's really quite unbelievable: global markets continue to slump . . . the bond market crash worsens. The financial losses so far this year are simply stupendous (as we will review). Yet, it seems all so surreal . . . as if in a movie. There's no connection to reality. The financial elites continue in their denial phase, arguing that either it shouldn't be happening or that there are plenty of reasons that recoveries will soon begin. Seriously, just what will it take to awaken investors to the fact that something is going fundamentally awry? Even more naive is the thought that the huge rises in long-term interest rates — in some countries to the highest levels in two years —will have no impact on economic prospects. Given how low interest rates needed to be to kick-start economic growth to begin with, this view is surprising. The fact is that virtually every consensus belief has been turned on its ear so far this year, including the big hopes of a new bull trend in the U.S. dollar. Economic expectations will likely be disappointed as well. We think the world economic recovery will sputter out before year-end.

But will that be bullish for stock and bond markets or not? That's the key question for every investor. Slow growth, lower inflationary pressures and low short-term interest rates had been the sinecure for financial markets in the previous bull phase. Will that be the case again? We don't think so. It's all-important to get a grip on the notion that the great tide of finance and money over the past decade has definitely flipped over. It's a completely different environment, entirely foreign to the experience of most investors in the markets today. The Great Financial Bubble has begun its bust . . . to repeat, has only begun its bust.

CAPITAL MARKET PICTURE

To repeat, financial losses so far this year are enormous. However, it's important to place these developments in the context of the financial inflation — the Great Financial Bubble — that preceded. Bond markets have crashed; stock market declines have only started. While many global bond markets have plumbed multi-year lows recently, all the major stock markets (in local currency terms) are still above year-ago levels. (See table on the opposite page.) Though some stock markets such as Hong Kong and Mexico have fallen substantially from their highs (-26.5% and -19.7% respectively) they are still up 25.2% and 48.5% over year-ago levels.

The rises in long-term rates, creating steep bond market losses, are almost unconscionable. Ten-year rates have risen from their yearly lows anywhere from 138 basis points (1.38 percentage points or b.p.) for Japan to a staggering 342 b.p. for Australia. Canada and the U.K. have suffered increases of 291 b.p. and 246 b.p. each.

IMPOTENT PROFESSIONALS

The quotation on the front page which speaks of an ignorant captain was actually made in reference to the sudden stock market crash of 1929 and the following world depression. It's equally applicable to the global bond market crash that we've witnessed since the Fed first inched up its funds rate on February 4th of this year. We quote it to emphasize an important point: Don't rely on the advice of the financial and economic professionals within the major financial and government institutions. Most of them are just as confused as anybody else. Worse, they all have a vested interest in the performance of financial markets.

Though completely taken by surprise, these market opinion-makers, the cheerleaders — that is the economists and financial analysts of the banks and brokers — have been quick to seize a comforting and convenient explanation: A sudden sell-off in the bond markets has been precipitated by exaggerated

inflation fears triggered by the stirrings of a world economic recovery. This, they figure, caused investors to dump their bonds irrespective of yield and price.

Seen in this light, the bond crash is mainly the fault of disillusioned investors who, driven by false inflation fears, refused to follow the considered buy recommendations of the professional experts. These "pros," in their superior wisdom, continue to proclaim the excellent long-term fundamental underpinning of the bond markets as they did through the whole crash — low secular inflation levels and extremely attractive real interest rates. So, in their view, it's misplaced inflation fears that explains it all. Failing that, it's all written off as an unexplainable aberration.

Global Capital Market Trends

Global Equities

Selected Markets, % Change

Country (June 22)	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia	-4.0%	-6.4%	18.7%	-12.7%	18.4%
Canada	-5.6%	-4.7%	8.2%	-9.8%	9.0%
France	-6.9%	-14.4%	5.0%	-17.8%	2.1%
Germany	-6.3%	-12.2%	18.7%	-12.2%	15.5%
Hong Kong	-6.6%	-26.0%	25.2%	-26.5%	32.9%
Japan	-1.8%	13.4%	4.1%	-3.4%	14.4%
Mexico	-7.5%	-12.6%	48.5%	-19.7%	40.5%
Spain	-9.2%	-9.2%	14.5%	-16.9%	12.2%
U.K.	-0.5%	-12.8%	5.9%	-15.3%	5.0%
U.S.	-1.0%	-2.7%	2.3%	-5.1%	2.1%

Source: FTA Indices

Global 10-Year Interest Rates

Selected Markets		Basis Point Change				
Country (June 23)	Present Rate(%)	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia	9.23	89	296	203	0	342
Canada	9.19	69	262	186	0	291
France	7.78	111	194	80	-21	194
Germany	7.14	16	144	30	-15	144
Japan	4.41	68	137	0	0	138
Spain	10.53	87	246	40	0	276
U.K.	8.64	17	246	87	-8	246
U.S.	7.12	-9	128	124	-26	176

Source: Financial Times

Exchange Rates

Versus U.S. Dollar		% Change				
Country (June 23)	Present Rate	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia ($)	1.36	0.1%	7.6%	8.6%	-0.5%	11.9%
Canada ($)	1.28	0.1%	-4.5%	-7.8%	-8.0%	0.2%
France (FF)	5.49	2.5%	7.1%	1.6%	0.0%	9.2%
Germany(DM)	1.60	2.7%	7.7%	5.7%	-0.1%	8.6%
Japan (Yen)	101.1	3.1%	9.4%	5.1%	0.0%	10.0%
Spain (Pta)	128.5	2.0%	6.9%	-2.1%	-3.5%	8.8%
U.K.(Sterling)	0.65	1.9%	3.8%	3.8%	-0.8%	5.0%

These explanations of the bond market crash are just too convenient and self-serving. Firstly, they virtually exonerate the banks and brokers from any charge of ill-judged, excessive bullishness. Secondly, it essentially implies that this is a temporary correction or accident — like the October 1987 stock market crash — and will soon be followed by a strong recovery, rather than a dreaded, terminal melt down.

As our regular readers know, we have never subscribed to this "inflation-scare" theory. Our contention has always been that this global fall in bond prices has had very little to do with the average investor and inflation fears but everything to do with a sudden bursting of a huge speculative bubble primarily fuelled by none other than the U.S. Federal Reserve. Its prolonged, extreme monetary ease, exploited with abandon by financial institutions including banks, brokers, hedge funds and pension funds, launched what we think became the largest financial bubble in modern history. That's the real and continuing story, not the protestations and soothing ministrations of the global investment community. And as for the real story, much more has yet to be written.

THE PSYCHOLOGY OF THE CROWDS

Compared with the huge, credit-financed bond purchases of the institutional players, individual investors, who would be most concerned about inflation, have played a very minor role in the previous mania and

in the present crash. Their activity pales besides the trillions of dollars of bond purchases by the professional players, largely with borrowed money. In their constant pursuit of better relative performance than their competitors, the institutional investors powered the bond bubble on the upside. More risk, more leverage and exposure to longer maturities determined the winners during this phase. Presently, the same competitive game causes them to drive the bear market on the downside. Only now it's a strategy of less bonds and shorter maturities that's the winning strategy of the competitive performance sweepstakes.

This obsession with short-term performance, regardless of the inherent risks, has turned many institutional traders and fund managers around the world into speculative maniacs. What makes it worse is the fact that these large players have a tendency to follow trends . . . to move in packs. Since relative performance is the make-or-break of their careers, not absolute performance, they can't afford to bet against the trend for too long. In short, professional investors tend to run in the same direction at the same time. When a major change of direction finally does occur, the shift can be dramatic and sudden as all the birds flock off the branch together. For the most part, this has nothing to do with fundamentals — value, economic trends, inflationary expectations, for example. It's mostly just a crowd mentality.

If we believe what John Maynard Keynes wrote in the 1930s about the behavioural characteristics of institutional experts and investors, their notorious mob psychology is apparently nothing new today. To quote Keynes from his "General Theory" (Chapter 12): *"It might have been supposed that competition between expert professionals, possessing judgement and knowledge beyond that of the private investor, would correct the vagaries of the ignorant individual left to himself. It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise. For most of these are, in fact, largely concerned, not with the making of superior long-term forecasts of the probable yield, but with foreseeing changes in the conventional basis of valuation a short time ahead of the public.*

We have reached the third degree where we devote our intelligences to anticipate what average opinion expects the average opinion to be.

Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

In this context, Keynes also offers a distinction between "speculation" and "investment" that gives some food for thought about today's markets. He uses the term "speculation" for the activity of forecasting and anticipating the psychology of the markets, and the term "investment" for the activity of forecasting prospective yields. Verbatim: "*As the organization of investment markets improves, the risk of the predominance of speculation does increase.*"

FINANCIAL MARKETS: A LOST COMPASS

Cutting through this morass of psychological subterfuge, vested interests and just plain confusion, in the last issue we again set down our own radically-opposed opinion. We said: *"New setbacks in the financial markets are likely to choke off economic recovery prospects. The worst that can happen to global financial markets and the world economy is a prolonged fall of the U.S. dollar. Its continuous weakness despite a drastic narrowing of U.S./European interest rate differentials and the good news about the U.S. economy is alarming and ominous."*

When we wrote this just four weeks ago, it appeared to us that there was still more complacency and confusion in the markets than anxiety. We thought then that there was still a strong bias to see investment prospects in a favourable light. That is still the case. While financial markets may have been performing negatively, long-term fundamentals are still held to be very positive by the majority of observers. For one, it's believed that the U.S. economy is leading a world economic recovery. The consensus is also convinced that European economic growth is on a firm upswing. Even Japan has turned the corner, it's believed, on the evidence of a sharp burst of growth in the first quarter of this year. So, on the strength of all these favourable impressions, it's widely preached that the worst of the financial crash is largely over and that sustained market stability, if not a renewed rise, is just around the corner. Seen in this rosy light, of course, the bond crash simply doesn't make any sense.

Since that time, despite further market set-backs, we still read comments that *"the medium-term prospects for the global economy are much brighter than generally expected."* For bond markets, the bullish buzzword continues to be "*low inflation,*" and for stock markets, "*rising business profits.*" The International Monetary Conference (attended by the world's top central banks) held in London recently, concluded that *"inflation pressures in their economies were subdued, encouraging hopes of sustained economic recovery in industrialized countries."*

No doubt, as the plunge of stocks, bonds and the dollar has worsened and the associated losses accumulate, it is only natural that market sentiment has deteriorated somewhat. Yet, true bearishness is difficult to find. At worst, it's only short-term and in any case, few investors are willing to act on their bearish convictions. Most people insist on calling the unexpected, sharp downswings in the markets a "correction." There remains a deeply-ingrained refusal to accept the possibility of a prolonged bear market, let alone a crash. Therefore, to date, there has been no real capitulation of all these false beliefs. Given what we see developing, this has yet to happen.

THE BOND MARKET DILEMMA

It's worthwhile documenting the bond market crash of the past six months. After all, this decline is the worst since the 1930s for most of the major fixed-income markets. To begin with, U.S. bonds were clearly the spark that started the fire in the global fixed-income markets. Actually, they peaked as early as mid-October last year, well before the Fed's first modest rate hike. To a degree, the decline made some sense in America since a stronger-than-expected economic recovery provided a motivating backdrop for the Fed's first monetary tightening in five years. Given the continuously low inflation rates, the rise in bond yields up to early this year could convincingly be blamed on misplaced inflation fears.

Hoping to nip these fears in the bud and to resuscitate the bond market, Wall Street virtually begged the Fed for a rate hike . . . but only a little hike, please, just enough to demonstrate anti-inflation vigilance but not enough to stop the financial gravy train. So it happened, a quarter-point rise in the Fed funds rate. But, instead of booming again, the U.S. bond market crashed instead.

Hard on the heels of the U.S. bond market swoon, an even bigger surprise followed in Europe's fixed-income markets. This was a real blow since the fundamental "bull" case for European bonds seemed so ironclad. Here, as the consensus saw it, a heady mixture of low inflation, weak economic growth and the certain continuance of monetary easing guaranteed that European bonds could only rise. At the very least, an uncoupling from the U.S. market was seen as a shoe-in. So, no need to worry. But, even though monetary easing by the major European central banks continued, bonds plunged nonetheless.

An interesting and important feature of the bond crash in Europe is a new, general widening of the yield spreads versus German bonds, reversing the prior narrowing. Thus, another big speculative ploy of the recent past is being undone: namely, the idea that in global capital markets, interest rates must converge. Accordingly, the international bond speculation had long favoured the high-yielding currencies such as the Spanish peseta, the Canadian and Australian dollars, and the British Pound. Surprisingly, U.S. bonds have shown the best relative performance of all the major markets most recently. The greatest nasty surprise in recent weeks were French bonds. (See the performance table on page 3)

We can only hope that readers followed our advice this past year. As of late 1993, we increasingly advised caution, counselling to shorten maturities in the previously recommended hard currency bonds. Early this year, we heavily emphasized cash-equivalent investments and short-term bonds with a continuing focus on non-dollar assets. Acting on this advice would have spared investors the grief of one of the sharpest bond market declines of the past five decades.

HOW MUCH MORE TO LOSE?

So much for the past. What about the future? The safest thing to say is that the global bull market in stocks and bonds is over. There is not much to gain from trading the rallies; there is lots to lose in a true bear market. The only question that remains is how much downside risk is left . . . how much more can current investors yet expect to lose.

In the first place, we don't share the view that the bond markets have bottomed out. Of the huge bull positions that have been built up during the past year, relatively little seems to be liquidated. Those who were not forced out by the margin calls have tended to stick with their holdings, waiting for the rally that will cut their big losses. Cash market transactions have been minimal. Derivative activity, however, has remained fairly high, although slower than before. That demonstrates the tendency of investors to hedge their positions, not to sell them. Even if the overhang of potential sellers continues to stay on, the fact remains that there are no net new buyers. Yet everywhere we look, there are record-sized budget deficits that need new buyers to facilitate their financing.

In the last analysis, for all markets, it always comes down to the simple question of supply and demand. More than just falling inflation rates are required to lower bond yields. Essentially, what's needed are sufficient numbers of bond buyers. To believe in a sustained recovery of bond markets over time, we must therefore first identify a potential group of big, new buyers. At present, we just don't see any.

For now in this respect, the banks are playing a crucial role almost everywhere. They alone have unlimited buying power, provided the central banks supply them with sufficient reserves. To that end, banks have stepped in with heavy bond purchases in the past months, so much so that it's hard to imagine a continuation of this trend.

In the last letter, we drew attention to the heavy bond purchases of U.S. banks. During February to April, their buying reached a record annual rate of $140 billion. After abruptly slashing these purchases to zero in May, they became net sellers in early June. It seems the banks regarded the bond crash as a favourable buying opportunity at first. Now they appear to have their doubts.

German banks' bond purchases in the first three months of 1994 were perhaps even more spectacular, running at an annual rate of almost DM 200 billion (U.S. $125 billion). In the German case, however, much of this steep rise in bond holdings stems from unsold new issues or redemptions in the banks' mutual funds.

GERMANY'S MONEY PUZZLE

Germany's rampant money growth remains a unique feature in the world monetary scene. While monetary growth remains generally sluggish around the globe, Germany's is bounding. Its obvious cause is a massive monetization of government debt as reflected in the banks' soaring bond purchases. Nevertheless, we remain fairly relaxed about the potential inflationary implications of the strong monetary expansion. Why? Because its effect on the economy is largely offset by the soaring liquidity preference of private savers. The joint result of debt monetization and the individual's cash hoarding is the rampant money growth. Those who ring the inflation alarms obviously overlook the fact that these soaring hoards of money are basically investment reserves. It most likely will be spent on financial securities, not on goods.

That's why we see no reason to change our optimistic expectations about German inflation. Consumer price inflation is sure to fall to an annual rate of 2% and lower. If it weren't for oil and petroleum tax increases, it would already be at a level of 2.75%. Recent wage trends are a most pleasant development, as well. Labour agreements concluded so far in 1994 have been lower than expected, averaging well below 2% annual increases while productivity gains are again soaring.

The best development, however, indicating that the German economy is moving into better internal balance again, is the sharply improving trade balance. Currently, it is in surplus to the tune of DM 80 billion at an annualized rate. If it weren't for the huge payments to the European Community and Russia, the current account would be in surplus as well.

But, what's causing this extraordinary liquidity preference, this great desire for cash by the German public? In principle, there can only be two possible motives: inflation fears or bearishness towards German stocks and bonds at their present valuation levels. We're convinced it is the latter. In our view, this is very wise. For the German investor, falling or low inflation in itself is no reason to rush into securities. It's something that's taken for granted.

What could finally break the strong liquidity preference of the German saver? Nobody knows. The current trends in global financial asset markets are hardly inviting. However, as prices fall, at some point securities valuations will become attractive enough to motivate new buying. Nevertheless, we think it is misguided for the Bundesbank to cut short-term interest rates with the intention of driving investors out of deposits and into securities. It easily leads to an abuse of monetary policy as happened in the United States and other countries in recent years.

APPRAISING GLOBAL BOND MARKETS

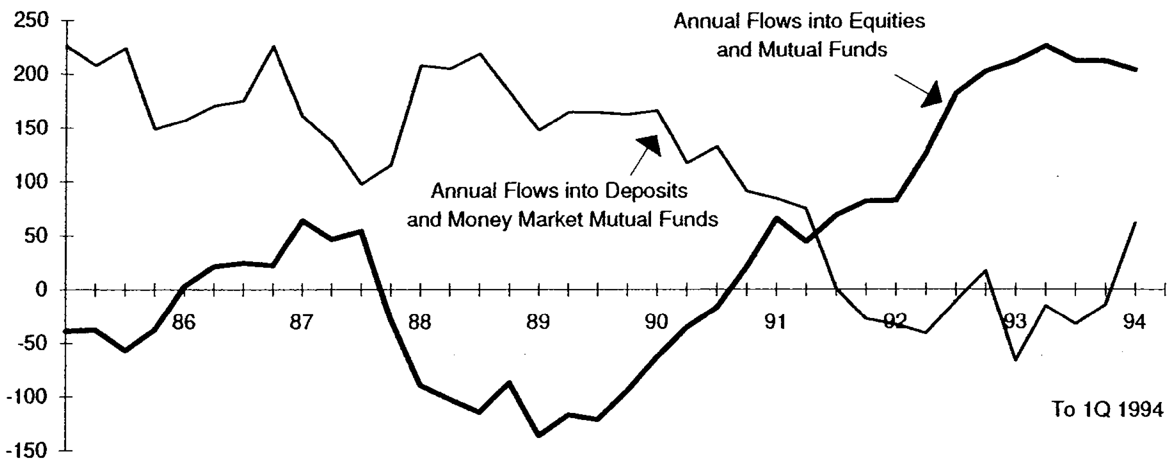
Any attempt to assess the prospects of economies and markets has to start with an appraisal of the bond crash. Being more confounded than dismayed, the popular view is that it is just a "correction." This tacitly presupposes that the whole bond debacle is virtually irrelevant for the economies and the stock markets. Imbedded in this view, as well, is this false notion that long-term interest rates are solely driven by inflation rates.

Our far more pessimistic assessment of the global bond crash and its implications is determined by a simple supply/demand analysis which focuses on the sources of the funds flowing into the capital markets. To review, the key test for a speculative "bubble" is the distinction between two sources of investible funds: 1) current savings; and 2) "inflation" in the broadest sense. This, by the way, was precisely the approach of the great, classical economists of the past. Admittedly, their methods need a

little more thought than simply using the newly-fashioned and simplistic yardsticks that ignorantly equate interest rates with inflation rates and a host of other irrelevant factors.

Let's first review the German bond market as an exercise in this classical approach. In the June letter (page 10), we showed in detail what fuelled its rampant boom last year — an unprecedented buying "bubble" on the part of non-resident investors and German banks. But what aspect qualifies most of these bond purchases as contributing to a "bubble"? In short, two things: firstly, these purchases involved massive money creation; and secondly, without a doubt, they were absolutely unsustainable at those levels. Theory aside, it was obvious that the foreign buying was pure, short-term speculation in any case. Primarily, it was a chase for quick capital gains, not investment.

U.S. FINANCIAL FLOWS: INDIVIDUALS
Billions of Dollars Annually, Quarterly, Since 1985



Source: Board of Governors of the Federal Reserve

Assessing the prospects of the German bond market therefore boils down to an appraisal of the probable supply of bonds versus the potential demand. The big negative unknowns in the equation are the foreign speculators. It was their massive buying that had driven interest rates to excessive lows late last year. Only a small part of these huge foreign-held positions have been liquidated so far. Many, if not most, are looking for an exit point. At worst, they may trigger a selling stampede. At best, they'll hold on to their positions. But new buying is out of the question. That alone is enough to depress the market.

The big, potential positive for the market is the highly-liquid and underinvested German public. But at what yield level will they begin to buy? Time will tell.

PROSPECTS FOR THE U.S. MARKETS

It goes without saying that we use the same measuring stick for all markets. The same two questions apply everywhere: To what extent was the recent boom underpinned by current savings? Was the recent boom driven by inflationary sources and capital inflows?

In the U.S. case, the funds flooding into the domestic financial markets have originated from far more diversified sources than in Germany. Just as clearly, most of these flows reflected loose money, not a rise in savings. Actually, personal savings have declined to new lows.

Here too, the pertinent question — apart from monetary aspects — is the sustainability of these flows. Typically, the U.S. financial boom of the past two, three years has been explained by falling inflation and the low short-term interest rates. In practical terms, of course, it needed buyers. In the U.S. case, the big surge in securities purchases driving bond yields down, came from foreign central banks, U.S. commercial banks, brokers and other non-bank institutions who were playing the steep yield curve. Although a lesser factor, buying also came from private investors who were escaping their existing low-yielding cash holdings. Together, the resulting flows into bonds ran into trillions of dollars, many times the amount of available savings.

In relative terms, private investors exerted the bullish influence on the much smaller-sized stock markets. Though the majority of them are not leveraged, there are two aspects that make them vulnerable nevertheless. Firstly, their heavy purchases via mutual funds took place rather late in the boom. Therefore the average purchase price is not very far below the market top. As well, this run-up in stock holdings was largely financed by a rundown in liquid assets.

As we've shown in past letters, this portfolio shift by individuals in recent years was the biggest on modern record. (See the graph on the opposite page). Clearly, the greatest beneficiaries of this shift were the stock markets. But, a lot of these investments are already underwater. What would happen if stock prices fall further? It's possible that a selling panic could be triggered. Given the record-sized shift into the stock market, we think this will happen.

We now ask ourselves a simple question: What will happen to all these investment flows now that market conditions have deteriorated so dramatically? How much of the bond buying during the past one to two years was speculative — a result of loose money? More than half, we guess. At best, most of these players have stopped buying. In reality, many of these former buyers will turn into net sellers as they try to reduce or liquidate their loss-making positions. Considering the huge overhang of these positions, we can only conclude that the collapse for the global demand for stocks and bonds will be with us for a long time.

DELAYED REALITY FOR STOCK MARKETS

The astonishing thing to this point is the remarkable resilience of the stock markets in relation to the bond market crash. Their insularity has two obvious reasons: One is that the sharp rise in long-term interest rates is not taken very seriously; the other is the expectation that an imminent world economic recovery will underpin the stock markets with big rises in corporate earnings.

We think that the global blow-off in the bond markets will definitely have an impact, although in a delayed fashion once it sinks in that interest rates aren't going to make a rapid recovery. Why? Firstly, the reality is that long-term rates have risen faster than short-term rates since last year. That's not the cyclical norm. Usually, it's short-term rates that lead long-term rates. Secondly, the largest sectors of the economies — housing, automotive and investment — which play a key role in cyclical recoveries, are most sensitive to long-term rates. That's why we believe the sharp rise in long rates will seriously hurt some economies. The U.S. economy is certainly one of these.

Given the fact that both the big wealth effect from booming financial markets and the large income effect from the refinance boom in mortgages have played an all-important role in boosting consumer spending in the U.S., it should be self-evident that the economy will slow significantly if these two stimulants cease. If the financial markets fail to recover — certainly if they weaken — we expect that U.S.

economic growth will soon surprise on the downside. That would be an unwelcome complication for the budding world economic recovery.

But isn't a weaker-than-expected economy a boon to financial markets if it serves to extinguish the smouldering inflation fears? Not necessarily. Unexpected U.S. economic weakness would pull the rug out from under the dollar. As well, profit expectations would fall sharply in tandem with an economic slowdown and thereby undermine the stock markets. A plunging dollar would roil the U.S. stock and bond markets further, thereby thrusting the Federal Reserve onto the horns of a dilemma.

A TIGHT SPOT FOR THE FED

The Fed's dilemma: Should it boost short-term interest rates to defend the dollar? If it does, it would put more pressure on markets and the economy. Then should the Fed let the dollar fall? That would risk raising inflation fears and chase foreign investors out of the dollar, further driving down the stock market and pushing up long-term rates. Either way, a recovery is in danger.

Without question, the U.S. dollar's plunge has been the surprise of the year for the whole world financial community. Expecting robust U.S. economic growth and rising interest rates as against economic doldrums and declining interest rates in Continental Europe and Japan, it was an article of faith that the dollar had nowhere to go but up. It was considered such a sure-fire bet that virtually the entire financial community went long in the dollar. Mostly they still are, immobilized by disbelief.

Given the recent developments in the currency markets, we think that the dollar question is becoming pivotal for all investment decisions. As for the causes of the dollar's decline, we can only repeat what we have expounded on for years. Primarily and fundamentally, its weakness is rooted in structural maladjustments that have accumulated over many years. These make a long list: record-low savings and investment ratios; near-stagnation in the industrial capital stock; a big shift toward short-term investment; an inflation-prone economy; large malinvestments in real estate and the consumer-oriented sector; a rising consumption share of GDP; a huge government budget deficit; large and soaring trade- and current-account deficits; and record-high private indebtedness.

WHERE THINGS WENT WRONG FOR THE DOLLAR

All these structural factors boil down to one central fact: For many years America has boosted its consumption by investing less and borrowing more from the rest of the world. It worked magnificently for many years, convincing most that it could continue forever. But why does the dollar crack now?

The answer, in our view, is to be found in the Fed's recent and current monetary stance. Here also lies the crucial error of the dollar bulls. Their assumption that the dollar should rise against the D-mark whenever U.S. growth pulls ahead of Europe's is essentially a correct one. What they overlooked is the key role of relative monetary conditions in drawing foreign money and capital into the dollar. Put simply, everything depends on the degree of Fed tightening relative to monetary conditions abroad.

Is U.S. monetary policy really tight? We don't think so. It surely is not as flagrantly loose as it was. But it's certainly not tight. Reserves are still not a restraining factor for the banking sector. The Fed is delivering whatever is needed. What is strange is that the reserve requirements of the banks are now stagnating. That has an even stranger reason: The banks have been fully financing the expansion of their total loans and investments by borrowing on the Euromarket. This requires no reserves and does not show up in their deposits. Over the last 12-months (up to the end of May) total bank assets expanded by

$78 billion, or 2.6%, while Eurodollar borrowings rose by $105 billion, a huge 125% increase. That has been a huge source of demand for the dollar. What does this mean? Given the fact that the dollar has been weak despite these huge foreign borrowings by the U.S. banks, makes the dollar's outlook appear even more scary.

Just as worrisome is a second implication of this development: The fact that such a modest loan expansion by the U.S. banks is completely dependent on foreign borrowing. Last but not least, the third ominous indication is found in the new record lows in money growth. Overall liquidity is rapidly tightening, though monetary policy remains extremely easy.

A LOOMING LIQUIDITY DISASTER IN THE U.S.

What is the cause of these deteriorating trends in the U.S. banking system? The favourite scapegoat is the saver who is switching assets out of bank deposits into mutual funds. As money leaves the bank for the securities markets, so the explanation goes, the money stock essentially falls. Though this is widely received as the truth, it's again so much poppycock. In itself, the buying and selling of mutual funds leaves the total money stock unchanged. The mutual fund that receives a check from a buyer must again deposit the money in its own bank account. Therefore, the money stock must stay the same.

What then is draining the deposit base of American banks and forcing them to fund their modest balance sheet expansion in the Euromarket? There is an obvious cause: the ballooning current-account deficit, running currently at an annual rate of $133 billion which essentially implies a corresponding excess of U.S. payments versus receipts from abroad. As domestic money supply is generally transferred to foreign banks, most of this money, in fact, exits the U.S. banks and the money stock. The same also applies to the capital and portfolio outflows which involve cash payments.

Much is being written about the economic causes and implications of the soaring U.S. trade- and current-account deficit, but virtually no one sounds the alert as to its monetary impact. These deficits act as a huge suction pump on U.S. domestic liquidity. Of course, this has been going on for years. But in the past, the dollars flowing out via the current-account deficit were readily recycled back through correspondingly-high capital inflows. As well, domestic credit and money creation were stronger then. What makes it so critical now? It's the precarious confluence of a new surge in the trade and current-account deficits, very weak domestic money creation and a sharply weakening capital account. Money outflows have overtaken voluntary inflows. The striking proof of that is the falling dollar.

Few people are aware that liquidity trends in the United States are extremely abysmal. Astoundingly, since the end of 1989, the ratio of broad money (M3) to national income has plummeted from 90.5% to a low of 78.7%. Such a downtrend, let alone such a steep one, is unprecedented in the postwar period. Yet, all the same, financial markets boomed and the economy recovered. How could this happen?

The foolhardy slogan of Wall Street, "cash is trash," points to the answer. People didn't respond to this shrinkage of liquidity in the normal way by cutting their expenditures. Why? Because they had a low demand for liquidity, thanks to Mr. Greenspan who punished cash holdings with zero real interest rates.

Instead of adapting to the liquidity crunch, people financed their rising purchases of goods and securities through a massive run-off of their existing low-yielding cash holdings. It is this famous, huge portfolio shift that made it possible for the economy and the financial markets to uncouple from the very sluggish money growth.

No doubt, the Fed's policy was a great success in the short-run, above all on Wall Street. Unfortunately, it spells disaster over the long-run. Once people awaken from the "cash is trash" illusion and conclude that they want to rebuild their liquid assets — essentially, by selling stocks and bonds — the wildly inflated financial market will collapse like a house of cards.

CONCLUSIONS

As we write, one can sense that the bust of the Great Financial Bubble is gaining momentum. Equity markets are finally becoming alarmed over the soaring bond yields.

We expect that any rallies will be quickly aborted. Most of the financial community has given up looking for new highs in stock and bond prices and is waiting for any reasonable opportunity to minimize losses. To us, that makes a strong case for selling now, no matter what the present losses.

Particularly alarming — possibly cataclysmic — for the global market sentiment, is the reeling U.S. dollar. More than anything else, its plunge signals that governments and central banks have lost control. In our view, they have indeed.

What should investors do now? Even though the declines are already quite steep, it's not too late to act on our long-standing recommendation. We continue to maintain a strong preference for the hard currencies countries — Germany, Switzerland, Austria and the Netherlands. Above all, hold on to liquidity. Only focus on cash securities and shorter-term bonds.

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